Written Testimony
Submitted for the Record
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Hearing on Certain Expiring Tax Provisions
April 26, 2012

The National Automobile Dealers Association ("NADA") appreciates the opportunity to provide this statement for the record in connection with the April 26, 2012 Subcommittee on Select Revenue Measures ("Subcommittee") hearing on certain expiring provisions. NADA represents 16,000 new car and truck dealers, both domestic and international. NADA also operates NADA Used Car Guide, which has been in production since 1933. Federal officials in the Department of Justice and the Federal Bureau of Investigation use NADA Used Car Guide as a used vehicle valuation source for asset and forfeiture purposes, while the Social Security Administration uses NADA Used Car Guide as a used vehicle valuation source to help determine benefits.

We focus our remarks on Section 512(b)(13)(E) of the Internal Revenue Code, as originally enacted by Section 1205 of the Pension Protection Act of 2006 (PPA) (P.L. 109-280), and subsequently extended by Section 306 of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (P.L. 110-343) and Section 747 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L 111-312). Section 512(b)(13(E) expired at the end of 2011, and NADA supports the permanent extension of this provision, as well as an expansion of the provision to ensure consistent treatment of all similarly situated tax-exempt organizations.

HISTORY OF THE PROVISION

Payments of passive income, including interest, rents, royalties, and annuities, are generally not subject to tax when received by tax-exempt organizations (i.e., such income is not treated as unrelated business taxable income (UBTI)). See, e.g., Sections 512(b)(1), (2) and (3). Under Sections 512(b)(13), however, these payments are subject to tax if they are received from a "controlled organization." For purposes of this provision, an organization is considered a controlled organization if the tax-exempt organization had a direct or indirect ownership interest of 50 percent or more in that organization.

Section 1205 of the PPA enacted Section 512(b)(13)(E), which provides that interest, rents, royalties and annuities received by a tax-exempt organization from a controlled organization will only be taxed when the payment exceeds fair market value (i.e. the amount which would have been paid if such payment met the requirements of Section 482). A 20 percent penalty is imposed on the amount of any excessive payments. Section 512(b)(13)(E) only applies to payments made under binding written contracts (or their renewals under substantially similar terms) in effect on the date of enactment of the provision (i.e., August 17, 2006). This "fair market" test has now been in effect for tax years 2006-2011.

Section 512(b)(13)(E) corrected an anomaly which resulted in tax-exempt organizations becoming liable for UBTI on payments of passive income even when they reflect fair market amounts. For example, many tax-exempt organizations receive rents at an "arm's length" amount from taxable subsidiaries that were established and operate for non-abusive purposes. Prior to the enactment of Section 512(b)(13)(E), these tax-exempt organizations were subject to tax, even though their receipt of rents from unrelated organizations under the exact same terms would not be subject to tax.

By incorporating Section 482, Section 512(b)(13)(E) recognizes that fair market value can be established generally by reference to amounts paid in comparable arrangements by unrelated third parties. The Internal Revenue Service ("IRS") has extensive experience in determining the fair market value of transfers between related parties under Section 482 and already applies Section 482 principles to other transactions involving tax-exempt organizations. For example, IRS letter rulings hold that tax-exempt organizations must comply with Section 482 in transfers of tax-exempt property. Since both the IRS and taxpayers have experience with these principles, the potential for abuse in this arena is limited. Moreover, tax-exempt organizations that receive interest, rent, royalty or annuity payments from a controlled organization must report payments on informational tax returns which provide a readily available, publicly transparent audit trail to identify potential abuses.

SECTION 512(B)(13)(E) SHOULD BE PERMANENTLY EXTENDED

As noted above, Section 512(b)(13)(E) expired at the end of 2011. We urge the Subcommittee to permanently extend the provision, retroactive to January 1, 2012. This extension if particularly important at a time when government funding of many tax-exempt organizations is being substantially reduced such that the organizations must enter into transactions with private sector organizations in order to pursue their tax-exempt purposes. Extension of Section 512(b)(13)(E) will enable tax-exempt organizations to enter into arm's length, fair market value transactions with private sector organizations without an additional tax burden that would reduce the resources they can devote to their tax-exempt purposes.

We note that the American Bar Association Section of Taxation has also recommended the permanent extension of Section 512(b)(13)(E), noting "the substantive changes of section 512(b)(13) made by the PPA should be made permanent. Inflated pricing in related-party transactions would remain taxable (with a penalty), while arm's length dealings could continue. This approach would place tax-exempt organizations on the same footing as taxable entities and would no longer penalize transactions between tax-exempt organizations and their related organizations."[1]

[1] American Bar Association, Section of Taxation, Comments in Response to the Request of the Subcommittee on Oversight of the Ways and Means Committee Regarding the Provisions of the Pension Protection Act of 2006 Affecting Tax Exempt Organizations (Aug. 6, 2007).

SECTION 512(B)(13)(E) SHOULD BE EXPANDED

We urge the Subcommittee to include perfecting language in Section 512(b)(13)(E)to advance the tax policy inherent in the statute and prevent the inconsistent treatment of similarly-situated tax exempt organizations. Section 512(b)(13)(E) currently only applies to so-called "qualified specified payments," which are defined as payments made pursuant to a binding contract in effect as of the date of enactment of the PPA (August 17, 2006) or a contract which is "a renewal, under substantially similar terms" of such a contract. We urge the Subcommittee to remove the "qualified specified payment" concept in order to expand the application of Section 512(b)(13(E) beyond payments pursuant to contracts "grandfathered" by PPA such that it applies to qualifying payments made under any contract (regardless of the date of such contract). This expansion would ensure consistent treatment of similarly situated tax-exempt organizations that engage in arm's length, fair market value transactions with controlled organizations, regardless of the date of the underlying contract.[2]

NADA POSITION

Section 512(b)(13)(E) should be made permanent and should be expanded to cover payments pursuant to new as well as grandfathered contracts between tax-exempt organizations and their controlled organizations. The well-established principles of Section 512(b)(13)(E) have now been applied for six years, so there is every reason to make this provision permanent. In so doing, Congress will also prevent any new, long-term uncertainty that the expiration of the provision creates for many tax-exempt organizations.

NADA commends Chairman Tiberi, Ranking Member Neal and the entire Subcommittee for actively considering the extension of expiring tax provisions, appreciates the opportunity to provide comments on this important matter, and urges expeditious action to achieve permanent tax law in this area.

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[2] In the event the Subcommittee retains the "qualifying specified payment" concept, we urge the Subcommittee to expand that concept to include not only renewals under substantially similar terms of "grandfathered" contracts but also new contracts with substantially similar terms to such "grandfathered" contracts, as commercial necessities may require the execution of a new contract rather than the renewal of an existing contract.